

Activity Based Costing/
Management Described

ACTIVITY BASED COSTING (ABC) VS. TRADITIONAL
COST ACCOUNTING

ABC's basic premise is that cost objects consume activities and that these activities in turn consume resources. This consumption of resources is what drives costs. Understanding the relationship of consumption to costs is critical to successfully managing indirect costs (overhead). Traditional cost accounting arbitrarily allocates overhead to cost objects by assuming there is a relationship between overhead and the volume of cost objects produced. The relationship is real but imprecisely measured.

DIFFERENCE BETWEEN ABC AND ABM

Activity Based Costing (ABC) is a technique generally applied to measure a single product's or service's true cost. Activity Based Management (ABM) uses such cost information across a range of products or services to evaluate the total costs of managing an entire operation.

HOW WIDELY IS ABC/M USED?

ABC has spread rapidly — but not as fast as hoped. One reason is that it involves a trade-off: for the sake of more cost accuracy, an organization must spend more time and resources counting and measuring the activities that drive costs. Even when a clear benefit is expected, reprogramming the necessary systems can be a massive undertaking.

What's Been Happening:

- DoD officials repeatedly stress that the ultimate goal of financial management reform measures is ensuring useful financial information for sound decision-making, not merely clean audit opinions on annual financial statements.
- In 2000, the Pentagon authorized a pilot program to test activity based costing concepts in four organizations/ activities: The Air Force flying hour program (HQ/USAF), and selected programs at AF Materiel Command, Defense Finance & Accounting Service, and US Transportation Command.
- ABC/M promises new techniques for making direct comparisons and choices between competing methods for accomplishing DoD's mission.

Key Players:

- Decision Makers: Under Secretary of Defense (Comptroller) and Comptrollers/Chief Financial Officers of the Services.
- Implementers: Director of Program, Analysis and Evaluation; and the chief financial officers of the military departments.
- Influencers: Members and key staff of Congressional Armed Services, Appropriations, and Government Reform Committees.

Challenges:

- Funding the upfront investments for transition and training costs involved in adopting Activity Based Costing and Management widely in the Department.
- Overcoming institutional resistance.

WHY WE NEED TO IMPLEMENT ACTIVITY
BASED COSTING AND MANAGEMENT THROUGH
DoD'S SUPPORT ACTIVITIES

Activity Based Costing (ABC) attempts to derive the “true” cost of an object, i.e., a product, process, or service, by including indirect costs. ABC provides costs by activities and processes.

This approach is different from traditional Pentagon accounting that was designed to ensure funds were spent on purposes approved by Congress. Under that approach, costs are accumulated by organization and category.

ABC improves product/service cost accuracy and helps align resource consumption with strategic goals.

With true cost information, managers can buy smarter and determine the results of competitions more rationally.

Activity Based Costing and Management will also help the DoD to comply with legislation requiring auditable annual financial statements.

Commissioners

Warren B. Rudman
Josh S. Weston
Raphael Benaroya
Denis A. Bovin
Charles A. Bowsher
Howard “Bo” Callaway
Michael S. Fields
Sidney Harman
Anita K. Jones
James R. Jones
James V. Kimsey
Alex J. Mandl

Bernard Marcus
Ann McLaughlin
John P. Morgridge
William F. Murdy
Sam Nunn
Admiral William A.
Owens, USN (Ret.)
William J. Rouhana, Jr.
Frederick W. Smith
Vin Weber
Mortimer B. Zuckerman

Senior Advisors

Frank C. Carlucci
William J. Perry

Business Executives
for National Security

Stanley A. Weiss,
Chairman

General Richard D.
Hearney, USMC (Ret.),
President & CEO

Business Executives
for National Security

IMPLEMENT ACTIVITY BASED COSTING
AND MANAGEMENT THROUGHOUT DoD

Tail-to-Tooth
Commission

The Department of Defense
should implement Activity Based
Costing and Management (ABC/M)
throughout its support activities

“No major part of DoD’s operations
has been able to pass the test of
an independent financial audit?...
If available, [complete financial]
information could provide useful
perspectives to decision makers
on such key areas as budget
requests, performance measure-
ment, and costs.”

–GAO Report “Major Management Challenges
and Program Risks” Department of Defense,
January 2001

Implement activity based costing and management (ABC/M) throughout DoD

Starting with the firm commitment and public support of the Secretary of Defense and his deputies

Enlist the support of the Directors of Activity Based Costing Pilot Programs to accelerate development of lessons learned for use in informing and convincing Service and Agency chiefs and Congress that ABC/M will work, that benefits are significant, and that ABC/M should be expanded to all support activities.

- Work with the Directors of the Pilot Programs to identify the most compelling success stories and lessons learned from current pilots.
- Arrange for these Directors to brief all Service Secretaries, Service Chiefs and Defense Agency heads.
- Arrange for these Directors to testify before Defense Authorization, Appropriations, and Government Reform Committees and Sub-committees on results of pilot programs and need for increased funding for transition costs.

Mobilize Comptrollers of the Office of the Secretary of Defense, Defense Agencies, and the Services to lead efforts to incorporate ABC/M systems and processes.

- Include need for improved accounting and management systems in Secretary and Deputy Secretary of Defense’s testimony to Congress.
- Include funding for investment in new systems in budgets of Services and Defense Agencies.
- Develop a comprehensive plan for implementation, drawing on examples of successes from federal, state, and local governments and private industry.

Convince Secretaries and Service Chiefs of the benefits of implementing ABC/M and that up-front costs will not be taken from vital programs or readiness.

- Work directly with Congressional committee leadership and key staff to gain increased funding for up-front costs.
- Support earmarking of additional funding for investment in new systems in budgets of Services and Defense Agencies.
- Ensure the principal financial managers for the Service Secretaries and Military Chiefs are educated in and supportive of efforts to implement ABC/M.
- Host industry briefings/roundtables to demonstrate benefits enjoyed by industry leaders employing ABC/M.
- Document success of pilot programs and invite program managers’ participation in identifying areas for expanding those pilot programs.

Reassure Congressional Appropriations Committees that ABC/M will not interfere with budget implementation or accountability.

- Document success of pilot programs in accounting for relevant appropriations while achieving increased accounting accuracy and transparency.
- Demonstrate return on investment of pilot programs and potential for increased return of additional investments by expanding programs to all support activities.

Where to find more information:

- 1994, *Activity Based Costing & Performance* by Karen Burk and Douglas Webster (American Management Systems, Inc., 703-267-5500).

- 1996, *Activity-Based Management – Making It Work: A Manager’s Guide to Implementing and Sustaining an Effective ABC System* by Gary Cokins (Irwin Professional Publications, 800-262-4729).

Result: DoD and Congressional
leaders are equipped with accurate, timely data
to manage better, save money, and improve investment decisions